OFFICE OF THE CONTROLLER

CITY OF PHILADELPHIA PENNSYLVANIA

REPORT ON INTERNAL CONTROL AND ON COMPLIANCE AND OTHER MATTERS FOR THE SCHOOL DISTRICT OF PHILADELPHIA

FISCAL 2004

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REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To the Chair and Members
of The School Reform Commission of the
School District of Philadelphia

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the School District of Philadelphia, Pennsylvania, a component unit of the City of Philadelphia, as of and for the year ended June 30, 2004, which collectively comprise the School District of Philadelphia, Pennsylvania's basic financial statements and have issued our report thereon dated December 23, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the School District of Philadelphia, Pennsylvania's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the School District of Philadelphia, Pennsylvania's ability to initiate, record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The following reportable conditions are discussed in greater detail in this report:

- Internal control procedures were inadequate for ensuring the accuracy of capital asset balances.

- Internal control deficiencies over cash accounts do not ensure accurate reporting and increase the risk of undetected errors or misappropriation of funds.
- Deficiencies exist in the District's controls over the administration and processing of payroll and fringe benefits.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the School District of Philadelphia, Pennsylvania's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

However, we noted certain conditions that are not required to be reported under *Government Auditing Standards*, but nonetheless represent deficiencies in internal control over financial reporting that should be addressed by management. These conditions are listed in the table of contents and included in this reporting package.

This report is intended solely for the information and use of the management of the School District of Philadelphia, Pennsylvania and the School Reform Commission and is not intended to be and should not be used by anyone other than these specified parties.

December 23, 2004

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Deputy City Controller

JONATHAN A. SAIDEL, CPA
City Controller

SCHOOL DISTRICT OF PHILADELPHIA

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CAPITAL ASSETS ACCOUNTING DEFICIENCIES

We noted numerous conditions that detract from the District's ability to properly, and accurately account for its capital assets. We attribute these conditions to the lack of a comprehensive capital asset policy. Such a policy is needed to systematically addresses the requirements of generally accepted accounting principles, the Public School Code of 1949, and the Pennsylvania Department of Education Accounting Manual.

Although a draft capital asset policy was prepared several years ago, it has not been officially adopted or consistently applied. With the initiation of the District's ambitious $2.3 billion multi-year capital improvement program, it is imperative that accountability over capital assets be strengthened.

We recommend that the District initiate a concerted effort to establish a comprehensive capital asset policy with detailed procedures, which at a minimum addresses the weaknesses discussed below. [60104.01]

Expenditures Not Reconciled

As noted in our previous reports, the District did not adequately reconcile capital expenditures with additions to capital assets.

Our current year review again disclosed that a periodic reconciliation of capital related expenditures in all funds and additions to capital assets was not prepared. A reconciliation, reviewed and approved for completeness and accuracy, would account for all capital expenditures and provide documentation of the decision process for determining which were capitalized and which were expensed. For fiscal 2004, District accounting records indicate that approximately $11.9 million of capital expenditures were incurred, but not capitalized. Without a reconciliation, the District cannot substantiate that these expenditures were properly recorded.

Failure to adequately reconcile capital expenditures with corresponding additions to capital assets increases the risk that non-current assets could be misstated or that non-capital items could be improperly paid from the Capital Projects Fund.

We continue to recommend that the District perform at least an annual reconciliation between capital related expenditures in all funds and additions to capital assets. The reconciliation should be reviewed and approved by supervisory personnel who should also review the underlying accounting records for completeness and accuracy. [60100.01]

Incorrect Estimated Asset Life Assignments

Capital assets such as personal and real property, were not depreciated in accordance with recommended estimated useful life tables. Failure to properly depreciate assets in accordance with their related asset life misstates expenditures and capital asset balances on the financial statements.

Although an official capital asset policy does not exist, we were informed that the District adopted the estimated useful life tables as developed and recommended by the Association of School Business Officials International (ASBO). To this end, the estimated useful lives for each asset class is recorded within the District's capital asset system (FASGOV) for use in the automatic computation of depreciation expense.

Our review disclosed multiple instances where personal property assets were not identified by the appropriate asset class within FASGOV, therefore distorting the computation of depreciation expense as follows:

- Vehicles totaling approximately $22.5 million with a life of 8 years are depreciated over 20 years.
- Computers totaling approximately $7.9 million with a life of 5 years are depreciated over 20 years.
- Musical instruments totaling approximately $402,000 with a life of 10 years are depreciated over 20 years.
- Athletic equipment totaling approximately $51,000 with a life of 10 years are depreciated over 20 years.
- Computers, musical instruments, and science lab equipment totaling approximately $340,000 with a life of 5 and 10 years, are classified as buildings and depreciated over 50 years.

In addition, we found similar problems with real property assets acquired with grant funds. Specifically, we noted approximately $6.3 million of building and related improvement assets that were being depreciated over 14 years. Such assets should have been assigned useful lives of 25 to 30 years.

Calculating asset depreciation over inappropriate useful lives can significantly misstate depreciation expense and accumulated depreciation on the financial statements as well as capital asset balances. For example, we recalculated depreciation expense using the correct estimated useful life for certain disposed school buses and found that current year depreciation expense and accumulated depreciation were understated by approximately $339,752 and $1,798,731, respectively. Additionally, depreciation expense for the real property purchased with grant funds was overstated by approximately $190,000. Although the misstatement amounts are not material to the financial statements, it is indicative of a lack of review procedures.

During 2004 the District initiated a review to ensure that prospectively (fiscal year 2004 and forward) personal property assets were classified correctly within FASGOV. However, a review of capital assets both personal and real property, already in FASGOV has not been performed.

We recommend that the District investigate the causes and adjust the records for the specific exceptions described above. We further recommend that the District establish policies and procedures to ensure that all capital assets are appropriately classified in the District capital asset system (FASGOV). [60104.02]

Inconsistent Depreciation Charges

Our testing disclosed that personal and real property assets were not depreciated on a consistent basis. Failure to depreciate assets on a consistent basis could result in misstated expenditures and capital asset balance on the financial statements.

Depreciation and accumulated depreciation are computed automatically by the District's new capital asset system (FASGOV). We were informed that it is the District's policy to depreciate assets depending on acquisition date. To this end, if the asset was purchased or available for use during the first six months of the fiscal year, a full year depreciation expense should be calculated. Assets purchased or available during the second six months are charged a half-year depreciation.

Our testing disclosed that when data was entered into the new FASGOV system, personal property assets placed in service during the first half of each fiscal year for all periods prior to fiscal 2004, were charged a half-year instead of a full-year depreciation per the District's policy. Further, all fiscal year 2004 additions to real property were charged a full-year depreciation regardless of when the asset was placed in service.

As a result, we identified an overstatement of depreciation expense and an understatement of accumulated depreciation amounting to $130,304 and $1.2 million, respectively.

We recommend that the District ensure that all capital assets are consistently depreciated based on established policy. [60104.03]

Improperly Supported Expenditure Transfers

In fiscal 2003 and 2004, the District transferred certain expenditures from the General to the Capital Projects Fund. These transfers were made under the premise that the expenditures more accurately represented capital improvements, or renovations for which capital bond funds may be expended per relevant bond covenants, rather than repairs and maintenance. As such, these expenditures were paid for with capital projects funds and those that were considered improvements or additions were capitalized. Our prior year testing of amounts transferred disclosed instances of unsupported expenditures and other costs that must be expensed according to generally accepted accounting principles. During fiscal 2004, the District transferred $2.6 million, representing salaries, benefits, and materials. Our review of documentation supporting the transfer noted that:

- Certain capitalized expenditures appeared to represent repairs and maintenance rather than improvements or additions. For instance, 4 out of the 10 expenditures reviewed consisted of painting projects.

- Amount capitalized for all 10 sample work orders tested did not agree with labor and materials amounts indicated on the work orders resulting in a net overstatement in capital improvements of $91,203.

Also, our review of additions to capital assets disclosed $1,022,988 in improvements that were only identified on the capital asset records by a journal voucher number. Further, the detailed descriptions for most of these assets were *"Awaiting documentation from Facilities."* Identifying additions to capital assets by the journal voucher number is not a proper identification method and should immediately be discontinued.

The supporting documentation primarily was derived from the AVANTIS work order system. A system that receives work orders and dispatches the appropriate personnel to the requesting location. This system was not designed to produce financial accounting data and does not interface with the District's financial accounting system (ADVANTAGE). Therefore substantial data mining is needed to calculate the expenditure transfer amounts mentioned above and compile related supporting documentation. Because the amounts were generated outside of the District's financial accounting system, and we found instances where the data generated by the AVANTIS system was unreliable, the transfers were considered high risk and therefore required extensive audit coverage.

We believe the transfers were necessitated and certain exceptions noted because the District has not established a formal policy stipulating the circumstances under which the use of capital bond funds are appropriate or indicating the criteria and methodology for the proper capitalization of expenditures.

We therefore recommend that the District develop a comprehensive capitalization policy. Until then, the District should consider discontinuing the practice of transferring expenditures in anticipation of capitalizing them. The capitalization policy should at a minimum incorporate the proper criteria for the use of capital bond funds and for the capitalization of expenditures. This policy should also establish detailed procedures should the transfer of costs from other funds become necessary and incorporate a proper review and approval system. [60104.04]

BANK RECONCILIATION AND CASH INTERNAL CONTROL DEFICIENCIES

In our prior year report, we disclosed that several internal control deficiencies existed over cash accounts. Our current year testing found that one control weakness cited, related to Categorical Funds, has been corrected, while others remain.[1] The following sections discuss control weaknesses still remaining, including any new conditions found as a result of our testing.

Equity in Pooled Cash and Investments

The District failed to adequately reconcile the ending equity in pooled cash and investments general ledger balance reported on the financial statements to the respective bank balances. Failure to adequately reconcile book to bank cash balances in a timely manner could result in financial statement misstatements or errors that could go undetected.

[1] See section concerning Status of Prior Year Finding for the control weakness that was corrected.

Our testing disclosed that the equity in pooled cash and investment balance reported on the financial statements was approximately $8.9 million less than the total reconciled book balances relating to the various banks comprising pooled cash and investments. Of that amount, we noted that $359,772 was due to two agency funds that erroneously were not included in the financial statements, while the remaining $8.6 million difference was not identified or reconciled by the District. This occurred because the bank reconciliations were performed using preliminary book balances presented in the general ledger. However, the reconciliations were not updated to reflect the activity and general ledger adjustments made in the subsequent months leading up to the final amounts presented in the financial statements.

An effective system of internal control incorporates the performance of proper reconciliations between the bank and ending book balances and includes a timely investigation of noted differences.

We therefore recommend that the District investigate the previously noted $8.6 million unreconciled difference between the book and bank balances. In addition, the District should establish procedures to ensure that final book balances presented in the financial statements are reconciled to bank balances and noted differences are thoroughly investigated and properly disposed. [60104.05]

Enterprise Fund – Food Services

In our previous report, we disclosed that the Food Services Fund Cafeteria Account bank reconciliations were not prepared timely, signed by either the preparer or reviewer, or properly prepared. These conditions detracted from management's ability to accurately report and safeguard the account.

Our current year testing disclosed that controls related to the accountability of this fund deteriorated during fiscal 2004. Specifically, we found that monthly bank reconciliations were not prepared at all during fiscal 2004. As a result, at June 2004, an unreconciled difference of $177,050 existed between the bank and the general ledger balance. District management informed us that they were aware of this control weakness and have instructed Food Service to immediately begin reconciling the account.

To minimize the risk of undetected errors or misappropriation of Food Services Fund cash, we again recommend that the District develop and implement written procedures for preparing bank reconciliations. [60103.02] At a minimum, these procedures should require:

- Preparing and reviewing bank reconciliations on a timely basis.
- Signing and dating bank reconciliations by both the preparer and the reviewer.
- Investigating and resolving reconciling items prior to the preparation of the subsequent reconciliation.
- Ensuring that the adjusted book balance equals the bank balance.

Fiduciary Fund – Student Activity Funds

We previously reported that controls over Student Activity Funds were weakened because certain reporting requirements as stipulated in the “Principal’s Financial Training Manual” were not followed. Specifically, we found that approximately half of our 20 sampled schools did not submit bank statements or prepare the bank reconciliation section of their Report on Student Activity Funds (EH-204 Form).

Our current year testing disclosed that this control weakness still exists. We again found that nine of 20 sampled schools did not submit the required bank statements to the Accounting Services Unit with their Report on Student Activity Funds and did not prepare the bank reconciliation section on the EH-204 Form.

To enhance internal controls and ensure accurate reporting of the Student Activity Funds on the financial statements, we again recommend that the District enforce its established policies and procedures relating to school reporting for Student Activity Funds. [60103.04]

General Fund – Petty Cash Imprest Funds

In our prior report, we noted that Petty Cash Imprest Fund requirements, as stipulated in the “Principal’s Financial Training Manual” were not consistently followed. The District has since implemented one of our recommendations and revised the petty cash guidelines to emphasize the importance of proper accountability over the petty cash funds by requiring the fund custodian to sign a form acknowledging their fiscal responsibilities. The District informed us that a few custodians refused to sign.

Despite these efforts, our current year testing disclosed similar conditions related to the operation of petty cash accounts located throughout the District. Specifically, our tests of petty cash funds at 12 schools disclosed the following weaknesses:

- Unreconciled differences, ranging from a $50 overage to a $425 shortage were found at eight schools.
- Monthly bank reconciliations were not prepared at four schools.
- Insufficient segregation of duties, whereby the fund custodian maintains the checkbook and also reconciles the petty cash fund, was noted at nine schools.
- Lack of documented evidence of supervisory review and approval of the monthly bank reconciliation was found at seven schools.
- ‘Cash in Bank’ balances were “plugged” in two Imprest Fund Reimbursement Requests, thereby forcing the reconciliation to the authorized fund amount.
- Petty cash funds were used to reimburse a student for a lost cell phone.
- Several non-sufficient fund charges totaling $105 were imposed to an account that was overdrawn.
- Invoices were split to avoid the $500 purchase limit in one account.
- A recent audit performed by District’s Audit Services Unit indicated a shortage that was to be reimbursed by the fund custodian by 3/31/04. Although we observed a check in the amount of $318 that was to be deposited into the account for restitution, as of the date of our test (5/10/04) it was not deposited.

To enhance internal controls and minimize the risk of undetected errors or misappropriation of petty cash funds, we again recommend that the District enforce its established policies and procedures relating to the management and reconciliation of all petty cash imprest funds. In addition, procedures should be established to address the disposition of cash shortages and overages. We further recommend that the District consider establishing a policy requiring the employees responsible for approving ineligible expenses to reimburse the petty cash fund for the cost of those expenses. Finally, the District should consider establishing a policy imposing disciplinary action against those custodians who refuse to acknowledge their fiscal responsibilities in writing. [60103.05]

PAYROLL AND FRINGE BENEFIT RELATED DEFICIENCIES

Payroll Approval

The District's payroll system requires the principal or administrator at each location to indicate final approval of the payroll by entering a "closeout" code into the computer. By doing so, the principal attests that time and attendance information is correct, individuals listed are bona-fide employees, and all entries to the payroll system are proper.

At 24 of 91 District locations visited, our testing disclosed that the payroll secretary, rather than the principal, approved attendance records. This condition existed because the principal, in a breach of confidentiality, delegated the approval authority and disclosed the closeout code to the payroll secretary. Furthermore, the principals at two of these locations admitted they did not have sufficient knowledge to access the system and perform the payroll approval functions.

Delegation of the authority for payroll approval violates payroll procedures, circumvents the system of internal controls, and seriously compromises the integrity of the payroll system by not ensuring an independent review of the payroll prior to its submission to the Payroll Department. This practice could result in the falsification of payroll time and attendance with little chance of detection.

Because the propriety of the payroll is dependent upon a proper independent review, we recommend the District take immediate corrective action to ensure the propriety of future payrolls. Specifically, we recommend that: closeout codes be re-issued to any principals who have shared their codes with other District personnel, principals be instructed regarding the necessity to maintain the confidentiality of their close-out codes, and sanctions be imposed upon principals who repeatedly disclose their closeout codes to other employees. [60104.06]

Health And Welfare Payments

The School District makes payments each pay period to various employee unions to provide health and welfare benefits for its members. These payments are based on the number of eligible members multiplied by the contractual rate. The District generates two reports, each indicating the number of employees for each union every pay period. One report is used to generate payments to the Philadelphia Federation of Teachers (PFT) while the other is used for the District's other unions.

For the last several years, we have reported that conflicting employee headcount data generated by the two computer reports indicated a possible error in amounts paid to employee unions. In fiscal year 2001, the District paid the PFT an additional $1.2 million to resolve an apparent underpayment indicated by the differing headcount totals from the two reports. During our current year audit, we noted biweekly differences indicating possible underpayments as large as $9,200 and overpayments as large as $143,700. The total net difference for the year indicates a possible overpayment to the PFT of $710,054.

We recommend that the District investigate this difference to determine whether the correct amounts were paid to the employee unions for 2004. We were informed that during fiscal 2005, the District developed and implemented one report to be used for health and welfare calculations for all unions, as recommended in our prior year report. We commend District management for implementing this corrective action and we will review the adequacy of the new report during next year's audit. [60100.05]

Employee Compensation Processing Procedures – Termination Compensation Control Weaknesses

In previous reports, we commented that the District's VPIL[2] report, which is the source of its annual Termination Compensation liability, included leave balances associated with a substantial number of former employees, some of whom had been separated from employment since 1999. We also reported that some of the former employees had been paid their Termination Compensation and, therefore, did not belong on the report. As a corrective measure, the District implemented a supplemental VPIL report that listed former employees whose termination compensations have been paid. It used the supplemental report to reduce the amount of Termination Compensation liability reflected in its financial statements without actually removing the employee names or liabilities from the VPIL report.

In fiscal year 2004, the District adjusted the VPIL listing by removing the names and corresponding Termination Compensation liability totaling $3.2 million for all employees who were inactive since 1999. Management took this action because it believed that these employees had already received their termination pay. A subsequent review conducted by the Audit Services Unit determined that the District could only verify $1.2 million in payments to the inactive employees. Consequently, the termination compensation liability was increased by $2 million for the remaining employees that were previously removed. Management informed us that they still believe that these employees received their termination compensation, but because of issues related to the implementation of a new accounting system in 1999, cannot easily determine that these payments were made.

In our opinion unpaid termination pay is subject to the Pennsylvania escheat laws which require submitting unclaimed wages to the state after two years. At the exit conference, District management indicated that prior to submitting funds to the state they plan to perform a detailed manual review on a case-by-case basis to document whether terminated compensation payments shown on the VPIL report have been made to these separated employees.

[2] VPIL = Vacation, Personal and Illness Leave

To ensure the accuracy of the District's financial statements, compliance with state law, and to reduce the risk of a recurrence of this condition, we recommend that:

- Management timely complete its detailed analysis of the VPIL report to determine the amount of unclaimed termination pay and, direct that this amount be immediately escheated to the state. [60102.08]

- Procedures to remove leave balances for terminated employees who have received their termination compensation payment be reduced to writing. [60102.10]

Employees Not Enrolled In Pension Plan

All full-time and part-time employees of the School District who render at least 80 days or 500 hours of service yearly are eligible to participate in the state Public School Employees Retirement System (PSERS). New employees enroll in the retirement system at the time they are hired, and contribute 7.5% of their qualifying compensation to the PSERS through payroll deductions. The District is also required to contribute its employer's share to PSERS which, for fiscal year 2004, was 3.77% of qualifying compensation.

During our test of employee payroll deductions, we noted that pension contributions were not being deducted from the wages of an employee hired in January 2003. Regulations require that employees be enrolled into the PSERS within 30 days of starting employment. We brought this matter to the attention of District personnel in the Employee Benefits Management unit who subsequently identified approximately 400 additional employees, hired between 1999 and 2004, who should be contributing to the pension plan, but were not.

District management believes this condition was caused by personnel in the District's Office of Human Resources failing to enroll these employees into the PSERS at the time they were hired. According to District personnel, changes made to the payroll system in 2000 allowed this condition to go undetected. They contend that the previous system contained an internal control feature which would not allow an employee to remain in the system if a retirement deduction was not made.

The District intends to contact all affected employees to inform them that they are not currently participants in the PSERS. Management also intends to arrange for the employees to purchase their uncredited service time. Because the District is responsible for matching the employee's contribution to the PSERS, it will be liable for the amount of the match and may be liable for interest charges on the unpaid balance. The amount of the District's liability cannot be readily determined because the employer's contributions will be based on salaries at the time the eligible service was performed.

We recommend that the District institute procedures to ensure that all new employees are enrolled in the PSERS. This may entail developing an automated program which performs bi-weekly comparisons of relevant data files to identify employees who are not contributing to the PSERS. Also, independent reviews of the documents prepared during the hiring process would aid in verifying that new employees are enrolled in the PSERS. [60104.08]

DEBT MANAGEMENT POLICY

As noted in our previous reports, the School District lacks a comprehensive written debt management policy to ensure better management of its growing debt burden. For example, at June 30, 1999, the District's net bonded debt was $784.3 million. During the five-year period ending June 30, 2004, net bonded debt increased over 192% to $2.3 billion. Considering that as of June 30, 2004, the District issued only $897 million of new debt as part of a $2.2 billion multi-year capital improvement program adopted in May 2004, it is clear that this trend will continue for the immediate future.

As we previously reported, a debt management policy provides written guidelines and restrictions that affect the amount and type of debt issue, the issuance process, and the management of the debt portfolio. Further, a debt management policy improves the quality of decisions, provides justification for the structure of debt issuance, identifies policy goals, and demonstrates a commitment to long-term financial planning, including a multi-year capital plan. Finally, adherence to a sound debt management policy signals to rating agencies and the capital markets that an entity is well managed and should meet its obligations in a timely manner.

During fiscal 2004, the District for the first time employed complex, derivative debt instruments that are subject to various risks. The Government Finance Officers Association (GFOA)[3] recommends that a comprehensive debt management policy specify the following relating to the use of derivative debt instruments:

- How the derivatives fit within the overall debt management program;
- The conditions under which derivatives can be utilized;
- The types of derivatives that may be employed or are prohibited;
- The methods for measuring, evaluating, and managing the specific risks associated with derivatives; and
- The methods for procuring and selecting derivative products.

We believe it is essential that the District adopt a comprehensive debt management policy because of its dramatically increasing debt burden and its recent use of long term borrowing to pay for normal operating costs such as termination compensation, personal computers, and building renovations.

Accordingly, we recommend that District management adopt a formal debt policy as recommended by the GFOA, review the policy annually and revise it as necessary. [60102.06]

[3] An independent organization dedicated to the sound management of government financial resources.

JOURNAL VOUCHER PROCEDURES

In our prior year letter to District management, we reported internal control weaknesses related to the authorization and processing procedures for journal voucher (JV) transactions. Our current year testing found that some of the control weaknesses cited have been corrected, while others remain.[4] The following section discusses the control weaknesses that are still remaining, including any new conditions found as a result of our testing.

Processing Weaknesses

JV Preparation Procedures

In our prior year report we noted that the District had previously established a policy requiring departments to include their unique agency codes and department prefixes in the record fields provided for such information in the ADVANTAGE system. However, this policy is not uniformly and accurately followed because it was never formally reduced to writing.

Our current year testing revealed that one department still does not comply with the established policy. Specifically, Financial Planning and Analysis (FPA) did not use the proper department prefix when preparing journal vouchers. We noted 107 JVs prepared by FPA that were entered without a prefix, prompting ADVANTAGE to assign a non-specific department prefix.

Failure to include the required data weakens controls over the accountability of JV processing and unnecessarily delays the audit process because of the difficulty in determining the originator of such transactions.

JV Numbering

To ensure easy access and reference capabilities during processing and future queries, the ADVANTAGE system automatically assigns a document number to each JV transaction. When a prefix is used, ADVANTAGE generates the rest of the JV number based on the number of documents (JV's) that have already used this prefix.

Our current year testing again revealed that FPA personnel were manually overriding the ADVANTAGE system's automated JV numbering process by entering a name or description in place of the system generated JV number. For instance, one JV number was identified as FPAPHONEC, while another FPATPG01164. This condition further weakens control over the accountability of JV transactions.

To improve controls over the accountability of JV transactions and to provide an effective audit trail, we again recommend that the District develop an effective enforcement policy to ensure compliance with its required procedures. [60103.06] We further recommend that District management establish procedures that preclude the manual manipulation of JV numbers. [60103.07].

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[4] See section concerning Status of Other Prior Year Findings for control weaknesses that were corrected.

MANAGEMENT REPRESENTATIONS REGARDING INTERNAL CONTROL

In conjunction with the annual audit of the District's CAFR, the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) confirm in a signed letter management's responsibility for the fair presentation of the financial statements, establishing and maintaining internal control and preventing and detecting fraud.

Currently there is no system in place to ensure that all significant internal control deficiencies or known frauds are brought to the attention of the CEO and CFO prior to signing the representation letter. As a result, internal control deficiencies and known defalcations may exist at the operating, academic or financial office level, and not be brought to management's attention. Since the CAFR is primarily comprised of financial transactions which originate at the various operating, academic or financial office levels, we believe that establishing and maintaining internal control and the detection of fraud is the responsibility of the heads of each of those offices.

We therefore recommend that management institute a system requiring each of the operating, academic and financial office heads to annually certify to the CFO that: there were no significant deficiencies in the design or operation of its internal accounting controls which could adversely affect the office's ability to record, process, summarize and report financial data; there were no instances of fraud, whether or not material, that involved management or other employees who have a significant role in internal controls; and, there were no significant changes in internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses. [60104.09]

Implementation of this recommendation would ensure that responsibility for establishing and maintaining internal control and preventing and detecting fraud is assigned to specific, responsible individuals at the operating, academic or financial office level. It would also provide a greater degree of assurance that the representations of management are correct and verifiable.

RETIREE'S LIFE INSURANCE COVERAGE

As required by union contracts, the School District is responsible for providing certain post-employment benefits to its retirees. As part of its contractual obligation, the District pays the monthly premiums on a group life insurance policy to provide up to $2,000 of life insurance per retiree. During our audit, we noted that the District's preliminary financial statements included a $21.1 million non-current liability at June 30, 2004 because management believed the District was responsible for paying the face value of the policy to the beneficiaries of deceased retirees.

Our research determined that the District is responsible for the payment of the contract premiums, but not the face value of the policy which will be paid by the insurance company in the event of retirees' deaths. District management processed an adjustment to correct the financial statements after we brought this matter to their attention.

To prevent similar problems in future years, we recommend that the District perform a detailed review of its accounting for all post-employment benefits to ensure that the related liabilities are accurately reported in the financial statements. [60104.10]

UNLOCATED PAYMENT VOUCHERS

In several of our previous reports, we commented on the District’s inability to locate certain payment vouchers that we requested for testing. In response, the District instituted corrective measures and, in the prior year, we observed a significant improvement which allowed us to consider the comment resolved. However, this condition recurred during our current year audit. District personnel could not locate 39 of the 322 (12%) sample payment vouchers that we requested for fiscal year 2004 testing. The 39 payment vouchers represent supporting documentation for approximately $7.2 million of the District's disbursements for the fiscal period.

Effective internal controls would ensure that valid payment vouchers and related documentation support all expenditures. In addition, the District's policy on public records requires the "retention of all fiscal records required for an audit until said audit has been received and approved." Federal grant regulations also dictate a three-year retention requirement for documents supporting expenditures related to federally funded programs.

Missing payment vouchers unnecessarily delay the audit process by requiring valuable time to be expended searching for them, identifying and observing alternate sources of documentation, or evaluating the effects of undocumented sample items. This condition also increases the risk that expenditures charged to federal programs will be declared ineligible for reimbursement if adequate payment documentation cannot be provided to support those expenditures.

We again recommend that District management establish procedures designed to ensure that payment vouchers are properly filed and maintained. Such procedures should include enhanced training regarding filing requirements and the use of 'out cards' or a sign-out sheet to document the employees who remove payment vouchers and the dates they are returned. [60104.11]

MINUTES TO PUBLIC MEETINGS

In previous reports, we noted that the District did not prepare or publish minutes of eighteen public meetings held by its governing body, the School Reform Commission (SRC), since the SRC’s inception in December 2001. Act 65 Pa. C.S. Section 706 of the State of Pennsylvania, titled “Minutes of Meetings, Public Records and Recording of Meetings,” (commonly called the Sunshine Act) requires that written minutes be prepared for all open meetings of agencies, including school governing bodies.

Our current year testing revealed the backlog of unprepared and unpublished minutes was reduced from eighteen to seven SRC meetings. District personnel informed us that they plan on completing the remaining minutes in the near future. We will continue to monitor this condition to determine whether the remaining minutes are provided. [60102.05].

STATUS OF OTHER PRIOR YEAR FINDINGS

As part of our current year audit, we followed up on conditions brought to management's attention in the prior year report. We will continue to pursue these conditions and report on them until management takes corrective action or until changes occur, making our recommendations obsolete. We blended the status of some prior-noted conditions with new observations and reported upon these matters in the previous sections of this report.[5]

Journal Voucher Procedures - Authorization Weaknesses

In previous reports, we noted numerous instances in which the District allowed individual employees to provide the two levels of approvals required by its accounting system and other employees to provide the second level approvals before subordinate first level approvals to process Journal Voucher (JV) transactions. We recommended that management develop and implement procedures to ensure that all such transactions are properly reviewed and approved by supervisory personnel who are independent of the transactions' preparation process.

Our current year review disclosed only 1 of 175 JV transactions for which one employee both prepared and approved the transaction. We also noted only five other instances in which second level approvals were obtained before subordinate first level approvals. These findings indicate that the District has made significant improvements in implementing our prior year recommendation. Therefore, we consider this finding resolved. [60101.03]. However, we will continue to monitor this condition to determine if a significant number of such authorization exceptions recur.

Allocation Procedures

As we noted in our prior report, the District used allocation procedures instead of specific association to report capital asset expenses in the various functional categories on the Statement of Activities. At the exit conference, we were informed that the District again used allocation procedures due to limitations of its automated accounting system.

Because we believe any resulting misallocation of costs would not materially misstate functional expenses reported on the Statement of Net Assets, we consider this comment resolved. [60102.04]

Unrecorded Donated Property

In our prior year report, we noted that certain donated property was not recorded on the District's personal property inventory records. Maintaining incomplete inventory records increases the risk of asset misappropriation, and misstates assets on the financial statements.

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[5]See sections concerning CAPITAL ASSETS ACCOUNTING DEFICIENCIES – Expenditures not Reconciled, BANK RECONCILIATION AND CASH INTERNAL CONTROL DEFICIENCIES – Enterprise Fund – Food Services, Fiduciary Fund – Student Activity Funds, General Fund – Petty Cash Imprest Funds, PAYROLL AND FRINGE BENEFIT RELATED DEFICIENCIES – Health and Welfare Payments, Termination Compensation Control Weaknesses, DEBT MANAGEMENT POLICY, JOURNAL VOUCHER PROCEDURES, and MINUTES TO PUBLIC MEETINGS.

Our current year review disclosed that the District prospectively implemented our recommendation and is now recording new donated personal property. However, we noted the unrecorded donated personal property identified in our prior year report and valued at approximately at $580,000 was still not added to the personal property records. Because of the corrective action taken we consider this finding resolved. [60103.01] However, until the prior year donated property is properly recorded, capital asset balances will continue to be understated by approximately $580,000.

Categorical Funds - Child Care Account

In our prior year report, we noted that June 2003 deposits in-transit totaling $125,613 were not included on the June 2003 bank reconciliation for the Child Care Program bank account. Failure to accurately and timely post cash receipts increases the risk of undetected errors or fraud occurring without timely detection.

Our current year review disclosed that deposits in-transit were properly included on the June 2004 bank reconciliation. Therefore, we consider this finding resolved. [60103.03]

Year-end Expenditure Review Procedures

In our prior year report, we noted that due to inadequate review procedures, $13.5 million in net vendor payments were recorded in the wrong fiscal period. To address this condition, the District's Accounting Department instituted a written policy which included year-end cutoff review procedures to ensure that invoices are processed in the correct fiscal period. Our current year audit tests revealed that, as a result of the corrective action, the net total of vendor payments processed in the wrong fiscal period decreased to an immaterial amount. Therefore, we consider this finding resolved. [60103.08]

Documents in Suspense Backlog

In our prior year report, we noted that the ADVANTAGE system had a significant backlog of purchase documents that were held in suspense, awaiting proper disposition. Subsequent to our fieldwork, the District established a written policy requiring issuing departments to monitor the progress of their expenditure documents and take appropriate action if they are not processed timely. Any such documents that are still pending after 90 days are automatically deleted by the ADVANTAGE system.

Our current year audit tests revealed that these corrective measures are in place and have resulted in a substantial reduction in the number of documents being held in suspense. Therefore, we consider this finding resolved. [60103.09 & 60103.10]

THE SCHOOL DISTRICT OF PHILADELPHIA
440 North Broad Street – Third Floor
PHILADELPHIA, PENNSYLVANIA 19130

Office of the Chief Financial Officer

215-400-4500
FAX: 215-400-4501

September 21, 2005

Via Hand Delivery
Jonathan A. Saidel, City Controller
City of Philadelphia
Office of the City Controller
12th Floor, Municipal Services Building
1401 John F. Kennedy Boulevard
Philadelphia, PA 19102

RE: Response to City's Report on Internal Control and on Compliance and Other Matters for The School District of Philadelphia – Fiscal Year 2004

Dear Honorable Saidel:

I would like to take this opportunity to first thank you and your staff for all of your efforts with respect to the above referenced matter.

As indicated in and acknowledged by your summary of the City's report, there were no instances of non-compliance or material weaknesses found during this most recent audit. In addition, all matters were either in accordance with and/or not *required* by the Government Finance Officers Association ("GFOA") or under Government Auditing Standards ("GAO"). As such, all "findings" or otherwise "reportable conditions" referenced in your report are recommendations for discussion purposes only and are meant to further assist executive and senior management staff with their continued reform efforts here at The School District of Philadelphia ("School District").

With that said, the attached Responses of the School District will summarize our formal responses to all matters contained in your report. As always, I remain,

Very truly yours,

Folasade Olanipekun
Chief Financial Officer

cc: Albert F. Scaperotto, Deputy City Controller
Anthony Radwanski, Deputy City Controller
James McNichol, Audit Administrator
Marcy Blender, Comptroller (School District)

THE SCHOOL DISTRICT OF PHILADELPHIA

FORMAL RESPONSES TO

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS

FOR FISCAL YEAR 2004

BY OFFICE OF THE CITY CONTROLLER CITY OF PHILADELPHIA

SUBMITTED BY:
FOLASADE A. OLANIPEKUN
CHIEF FINANCIAL OFFICER
SCHOOL DISTRICT OF PHILADELPHIA
September 21, 2005

School District of Philadelphia's Responses to Draft Report on Internal Controls and on Compliance and Other Matters - Fiscal Year 2004
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CAPITAL ASSETS AND ACCOUNTING DEFICIENCIES

General
Summary of Findings and Recommendations:

- Lack of a Comprehensive Capital Asset Policy

School District's Response:

- As noted in the Audit, a draft of a Capital Asset Policy and accompanying guidelines (the "Policy") was prepared and defined during the last fiscal year; however, the Policy was never formally or fully adopted or consistently applied despite its use and circulation. Subsequently, the School District of Philadelphia (the "School District") later identified the need for two separate policies: (i) a policy defining the capitalization, valuation and depreciation of real and personal property; and (ii) a policy defining capital accounting guidelines and measures for financial reporting purposes. Accordingly, the School District, by and through the Office of the Chief Financial Officer, will re-examine this initial Policy, make changes if necessary and present a comprehensive Policy to the School Reform Commission for its formal review and adoption within this calendar year. After its adoption, the School District will ensure that the Policy is implemented District-wide and that training sessions are held within appropriate departments and business units affected by any changes and formalization of the Policy.

Expenditures Not Reconciled
Summary of Findings and Recommendations:

- Failure to adequately reconcile capital expenditures with corresponding additions to capital assets

School District's Response:

- Since Fiscal Year 2003, the School District addressed noted deficiencies and implemented several improvements to its capital spending accounting processes and capital spending reconciliations. Moreover, the School District aggressively continues to identify improvements to its accounting systems and processes to achieve greater efficiency, accountability and accuracy. For instance, a capital spending reconciliation will be a formal and permanent part of the closing process beginning with Fiscal Year 2005 as well as standard monthly reconciliations of each bond fund. In addition, the School District created a new position entitled, Senior Fixed Asset Accountant within the Accounting Services Department, and in August of 2005 hired an individual whose primary responsibilities include the

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recording, documentation and reconciliation of all fixed assets. Collectively, these efforts will continue to improve upon the business and financial operations of the School District.

Incorrect Estimated Asset Life Assignments
Summary of Findings and Recommendations:

- Failure to properly depreciate real and personal property in accordance with estimated useful life tables as adopted
- Incorrect asset classifications and/or assignments found within FASGOV

School District's Response:

- At the outset, the School District recognized the need for and later adopted the estimated useful life tables as set forth in the Association of School Business Officials International ("ASBO") with its implementation of GASB34 and in conjunction with the population of the School District's new capital asset system or otherwise "FASGOV". As noted in the Audit and in January of 2004, the School District developed and implemented directives to ensure that personal property assets were coded correctly within FASGOV and internal samplings are now performed on a regular basis. However, the School District recognizes that no system is without human error. Consequently, the School District, by and through the Office of the Chief Financial Officer, will lead a comprehensive and complete review of all data contained within FASGOV to ensure that both real and personal property or assets are classified correctly by the appropriate asset class and coinciding useful life term before the end of this fiscal year. In addition, the School District will ensure that all depreciation tables and computation formulas are updated and all appropriate departments and business units are aware of proper asset classification coding on an annual basis hereinafter through various mediums including, but not limited to, training.

Inconsistent Depreciation Charges
Summary of Findings and Recommendations:

- Inconsistent depreciation and accumulated depreciation of capital assets with suspected understatements equaling $130,304 and $1.2 million respectively

School District's Response:

- As reflected in the School District's policy, the depreciation of fixed assets is dependent upon the acquisition date of the asset. For example, if an asset was purchased or made available for use during the first six months of the fiscal year

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then a full year of depreciation expense is calculated while an asset purchased or made available for use during the second half of the fiscal year is only afforded a half-year depreciation expense. Despite our clear policy, understatements of depreciation and accumulated depreciation were identified in a number of instances in the Audit. Consequently, the School District will research, review and correct any inconsistencies and make necessary adjustments. In addition and as part of a new comprehensive employee evaluation system, the Director and/or Manager of the appropriate business unit within the School District will conduct individual and quarterly periodic audits of employees responsible for this particular function to ensure consistent compliance with School District policy.

Improperly Supported Expenditure Transfers
Summary of Findings and Recommendations:

- Unsupported expenditure transfers totaling $2.6 million during Fiscal Year 2004 from the General Fund to the Capital Projects Fund
- Suspected overstatement of $91,203 in capital improvements
- Lack of documentation to support $1,022,988 of additions to capital assets and only identified by journal voucher number
- Lack of a comprehensive Capitalization Policy detailing proper criteria for the use of capital bond funds and for the capitalization of those expenditures

School District's Response:

- Although this type of transaction and its discontinuance will be specifically addressed in the School District's comprehensive Capital Asset Policy and accompanying guidelines (the "Policy"), new processes and procedures including approval systems were informally implemented in January of 2004. Today, each capital item is first approved and then charged immediately to the appropriate bond fund pursuant to its project number thus eliminating the prior need and practice of transferring costs to a capital fund via the use of a journal voucher with the exception of payroll entries. Monthly reconciliations of all bond fund accounts will be a standard business practice of the School District by the 2005 calendar year end. In addition, appropriate managers are charged with performing a weekly accounting analysis designed to ensure that all capital expenditures are charged to the appropriate capital fund. Likewise and as part of this continued reform effort, the Policy will address and make clear, for example, eligible uses of capital bond funds, criteria for approval of eligible expenditures of bond fund proceeds, methodology for the proper capitalization of expenditures, etc.

- Although the School District recognizes that its official accounting system, Advantage, and its facilities work order system, Advantis, are not immediately compatible, the School District recently implemented the use of off-line

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spreadsheets and review processes to systematically ensure that entries made in the Advantage system are accurate and supportable with secondary data in Advantis. Off-line improvements and supports to both data systems continue to be made by the School District senior management with an emphasis on efficiency and accuracy until a long-term on-line solution can be implemented.

BANK RECONCILAIATION AND CASH INTERNAL CONTROL DEFICIENCIES

Equity in Pooled Cash and Investments
Summary of Findings and Recommendations:

- Failure to adequately reconcile book to bank cash balances in a timely manner resulting in a suspected $8.6 million difference

School District's Response:

- Although bank reconciliations for all accounts and investment balances are now reconciled and current, the School District already identified the need to reconcile the bank balances to the amounts in the Advantage financial accounting system and/or General Ledger on a regular and persistent basis. This task or otherwise referred to as the "Cash Note Project" is currently underway and will be completed for the Fiscal Year 2005 close for both 2004 and 2005. After implementation, reconciliation will occur on a monthly basis in order to quickly identify and timely address deficiencies, if any, in account balances. Moreover, full and final book balances presented in financial statements will be formally reconciled with bank balances prior to submission of the School District's CAFR as part of our general close-out procedures.

Enterprise Fund – Food Services
Summary of Findings and Recommendations:

- Failure to prepare monthly bank reconciliations for the Food Services Fund Cafeteria Account resulting in a suspected $177,050 difference between the bank and general ledger balance
- Recommendation to develop and implement written procedures for preparing bank reconciliations

School District's Response:

- Because the School District recognized and identified weaknesses in the control mechanisms of both the vendor and internally, the School District developed

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documented procedures to reconcile food services bank accounts with the general ledger. These procedures include, for example, systematically preparing and reviewing bank reconciliations on a monthly basis, standard approval of reconciliations, the timeline for investigating and closing open items and bank deposit procedures. The School District envisions full implementation of these controls in the early part of Fiscal Year 2005.

Fiduciary Fund – Student Activity Funds
Summary of Findings and Recommendations:

- Failure of sampled schools to submit required bank statements and/or prepare bank reconciliation section contained within the Report on Student Activity Funds (EH-204 Form) pursuant to School District policy

School District's Response:

- In August of 2004, the School District implemented standards and policies for all principals that require both monthly bank reconciliation and quarterly student activity fund reporting. These standards are included in the Principal's Financial Training Manual and are emphasized, each year, at training. Furthermore, Regional Business Specialists are required to monitor and receive monthly reconciliations for all school bank accounts within their respective territory as part of the School District's internal control mechanisms and new accountability standards.

- Of the nine schools that purportedly failed to submit required bank statements with their reports and/or failed to complete the bank reconciliation section, the School District will forward each instance to the Office of School Management for further investigation and to the Office of the Inspector General if deemed fraudulent. Because this remains to be a challenge, however, the School District will begin to track schools who continually fail to adhere to these directives, provide additional training if necessary, perform periodic or random sampling throughout the school year to ensure consistent compliance and report both schools and Regional Superintendents for continued non-compliance in the future.

General Fund - Petty Cash Imprest Funds
Summary of Findings and Recommendations:

- Failure of sampled schools to perform monthly bank reconciliations and suspected un-reconciled differences ranging from $50 overages to $425 shortages
- Other deficiencies noted include the insufficient segregation of duties, lack of supervisory review and approval, "plugged" in balances, inappropriate

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petty cash usage and spending, overdrawn accounts, splitting of invoices to avoid $500 purchase limit per item, and un-deposited reimbursement check, all in violation of School District policy

School District's Response:

- As stated above, the same standards which were implemented for student activity funds are required for all school bank accounts which includes the proper accounting and reconciliation of general petty cash funds. For instance, monthly bank statement reconciliations are now formally required. If or when monthly reconciliations are not completed and submitted with reimbursement requests, petty cash accounts are not replenished until the account is fully reconciled. Original Invoices and Receipts are required for fund reimbursement, splitting invoices to avoid the $500.00 purchase limit is strictly prohibited, and appropriate control and reimbursement mechanisms for misappropriation of funds, are among the few accounting requirements now in place.

- As recommended, an addendum to the training manual will be prepared prior to the end of this calendar year to address the issue of segregation of duties, obligations of timely reimbursement for ineligible expenses, circumstances which warrant a breach of duty and appropriate disciplinary action for persons who are found to have breached their fiduciary duties either by omission, negligence or purposeful act within the parameters of applicable collective bargaining agreements.

- Because these issues continue to be a challenge, however, the School District will begin to track schools who continually fail to adhere to these directives and perform periodic or random sampling throughout the school year to ensure consistent compliance and report both schools and Regional Superintendents for continued non-compliance in the future. As such, this will become a standard internal audit function by the School District's Audit Services Unit.

PAYROLL AND FRINGE BENEFIT RELATED DEFICIENCIES

Payroll Approval
Summary of Findings and Recommendations:

- Inappropriate delegation of payroll closeout function and disclosure or sharing of confidential access/approval code to subordinates in direct violation of School District policy

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School District's Response:

- It is clearly stated in the School District's policy that principals and school administrators are not to share or divulge their passwords and user identification codes. Annual mandatory training is provided which emphasizes this policy and it is also documented in the Principal's Financial Training Manual. If the Advantage Administrator becomes aware of such a breach, the existing password and identification codes are immediately revoked and new ones are issued only after notifying the Office of School Management and appropriate Regional Superintendents. Consequently, the Office of School Management investigates all matters, conducts both formal and informal hearings, takes appropriate disciplinary action against violators pursuant to collective bargaining agreements and refers all suspected serious breaches for further investigation by the Office of the Inspector General.

- In August of 2005, a training session was held for all new principals where this directive was again emphasized. Also, a notice will be included in the monthly principal's bulletin reiterating this policy. Likewise, Regional Business Specialists and the School District's Audit Services Unit will be asked to and charged with conducting spot audits and random field visits throughout the school year in an effort to further ensure compliance.

- More specifically, the 24 of the 91 district locations cited in the Audit will be properly referred to the Office of School Management and Regional Superintendents for further investigation and appropriate disciplinary action, if warranted. Because this continues to be a challenge, however, the School District will begin to track principals who continually violate this directive and perform periodic or random sampling throughout the school year to ensure consistent compliance and report both principals and Regional Superintendents for continued non-compliance in the future. As such, this will become a standard internal audit function by the School District's Audit Services Unit.

Health and Welfare Payments
Summary of Findings and Recommendations:

- Conflicting employee headcount data generated by internal reports lending to a suspected overpayment of $710,054 to unions

School District's Response:

- As referenced in the Audit, a new single report was developed and adopted in August of 2004 to provide a more consistent and accurate employee headcount data for all unions pertaining to the proper calculation of health and welfare

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payments. Reconciliations are completed by the School District's Benefit Office who currently indicates that the proper amount was paid since the time of implementation and use of the new report format.

- Notwithstanding the above and although the School District believes that accurate payments were made to employees in Fiscal Year 2004, the School District will research this item in an effort to identify any under- or over- payments in this regard.

Employee Compensation Processing Procedures – Termination Compensation Control Weaknesses
Summary of Findings and Recommendations:

- Inability to confirm termination compensation payments to inactive employees by $2 million thereby requiring possible escheatment to the Commonwealth of Pennsylvania
- Lack of written procedures for removal of employees who have received termination compensation payments

School District's Response:

- The School District had no intention of including non-supportable termination pay liability numbers in its Financial Statements without proper verification that inactive employees were paid. Currently, the School District makes every attempt and effort and utilizes all reasonable means available to contact former employees, or the families of the deceased, as termination of employment occurs. Incremental improvements and reporting methods were implemented in May of 2004, and the School District is pursuing further automated solutions to compliment our efforts. Because the School District agrees that termination procedures should be formally documented and adopted, the School District will develop and implement a standard policy as recommended in the Audit.

- The School District is aware that non-cashed termination pay is subject to state escheat laws and the School District's obligations there under. As previously mentioned and acknowledged in the Audit, the implementation of the Advantage system in 1999 and subsequent reporting quirks concerning leave balances have lead to the belief that there are employees remaining on the system who were, in fact, paid. As a result, the School District initiated a project to manually validate all payments made and compare data with those existing in the system. Upon completion of this effort, any non-validated amounts will be escheated to the state as required by law.

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Employees Not Enrolled in Pension Plan
Summary of Findings and Recommendations:

- Failure of Office of Human Resources to enroll approximately 400 employees, hired between 1999 and 2004, in PSERS as required by the Commonwealth of Pennsylvania

School District's Response:

- As stated in the Audit, the School District was made aware of this error and developed an action plan in January of 2005 to correct all shortcomings with respect to employee payroll deductions and subsequent mandatory enrollment in PSERS. To this end, automated monthly reports are now created and generated which identify employees who are missing retirement contributions. In addition and once an employee is identified, the data is entered into Advantage and separately reported to PSERS. A standard letter is then generated and forwarded to the employee informing them of their mandatory contribution thereafter.

DEBT MANAGEMENT POLICY

General
Summary of Findings and Recommendations:

- Lack of a comprehensive Debt Management Policy

School District's Response:

- The issuance of debt by the School District is governed by the Local Unit Government Debt Act (the "Debt Act"). There are constant and regular presentations from and conversations with various rating agencies regarding the School District's capital plans and program and the School District's debt issuing calendar and capacity. Additionally, the School District is *only* required by the Debt Act to have a written Interest Rate Management Plan which is summarized in our CAFR. A written Debt Management Policy, as recommended in this Audit, is not required by any state regulatory or advisory board or agency and is *only* a recommendation of GFOA.

- Historically, the School District's expenditures for debt payments compared to overall expenditures are considered modest in the rating agency industry. For the Fiscal Year 2002 through Fiscal Year 2005, the debt ratio was 5.31%, 5.71%, 8.48% and 5.9% respectively. More recently and as reflected by its latest bond ratings, the City of Philadelphia's and the School District's combined debt burden

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is relatively high while the School District's direct debt burden is considered very moderate at 5.3% (pursuant to the Rating Report by Moody's Investors Service – dated 9/8/05). The School District believes this is a more indicative measure of its debt commitment.

- Moreover, the recent achievement of balanced operations despite an aggressive capital improvement program is of great importance, given years of large structural and operational deficits prior to state control. Therefore, the School District takes exception to the statement in the report asserting its "dramatically increasing debt burden" without any further explanation or qualification. In addition and in consultation with both in-house and outside legal counsel, the School District will only continue to issue debt if it fits within its approved financial plan.

- Furthermore and pursuant to provisions in both the Public School Code and the Debt Act, the School District is authorized to issue deficit bonds to cover certain qualified "operating" expenditures during a period and following a declaration of financial distress (which is strictly defined). More specifically and, in response to a larger participation in an early retirement incentive plan than was originally anticipated but appropriately budgeted, the School District issued bonds to cover termination payments for three years beginning in 2004 as prescribed and authorized by the Debt Act.

- Notwithstanding the above, the School District intends to formalize its debt practices and policies (as currently described in individual Official Statements when debt is issued), by contracting with an outside financial advisor. This advisor will be charged with preparing a formal policy for later presentation to and adoption by the School Reform Commission.

JOURNAL VOUCHER WEAKNESSES

Processing Weaknesses – JV Preparation Procedures and JV Numbering
Summary of Findings and Recommendations:

- Failure of certain identified employees within one business unit to use proper department prefixes when preparing journal vouchers

- Manual manipulation of journal voucher numbering

School District's Response:

- Because it already identified this shortcoming, the School District developed and issued written processes and procedures to ensure that journal vouchers prepared

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by and all business units within the Office of Management and Budget ("OMB") contain proper and consistent prefixes and numbers. This policy and written directive was shared with all OMB and Accounting Office staff members.

- Because these issues continue to be a challenge, however, the School District will begin to track business units and employees who continually fail to adhere to these directives and perform periodic or random sampling to ensure consistent compliance and take necessary disciplinary action, if and when warranted. As such, this will become a standard internal audit review function by the School District's Audit Services Unit.

MANAGEMENT REPRESENTATIONS REGARDING INTERNAL CONTROLS

General
Summary of Findings and Recommendations:

- Recommendation for annual certification by various operating, academic and financial department heads and/or managers

School District's Response:

- A comprehensive independent review of the School District's internal audit processes and audit plans and reports was recently completed by The Bronner Group, Inc. The creation of an independent committee to review audit findings and the development of a more formal audit program to include risk assessment methodologies and standard audit reporting practices are among the few recommendations contained in their final report. Furthermore, the School District is in the process of recruiting and intending to appoint a new Director of Auditing Services whose mission will be to implement many of these recommendations.

- Nevertheless, the School District agrees with the recommendation to require each of the operating, academic and financial directors or officers to annually certify to the CEO and CFO their knowledge and compliance with internal control practices and intend to implement this requirement in Fiscal Year 2005.

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RETIREE'S LIFE INSURANCE COVERAGE

General
Summary of Findings and Recommendations:

- Recommendation for annual detailed review of accounting for all post-employment benefits

School District's Response:

- There are only two post-retirement benefits currently available to qualified School District employees: (i) retiree life insurance coverage; and (ii) the 2004 early retirement incentive program payouts. Both these items will be properly recorded and captured in the financial statements for Fiscal Year 2005. As reflected in the Audit, the post-retirement benefit was properly recorded; *however*, the amount reported was slightly incorrect in the *preliminary* Financial Statements since the School District believed that it was responsible for payment of the face value of the policy to beneficiaries of deceased retirees. This was immediately corrected and not contained in *final* Financial Statements. In the future, the Benefits Unit within the Office of Human Resources will periodically inform the Accounting Office of the methodology and contractual obligations of the School District, in writing. Likewise, quarterly benefits reconciliations are currently completed for all benefits recorded in our data systems whether or not they are considered a pre- or post-retirement benefit.

UNLOCATED PAYMENT VOUCHERS

General
Summary of Findings and Recommendations:

- Failure to properly file and maintain payment vouchers and supporting documentation

School District's Response:

- Because the School District recognizes the need to improve its payment voucher filing processes and retention requirements, a cross-functional team consisting of senior members from Accounts Payable, Accounting, Systems Administration and Internal Auditing were tasked with process redesign, implementing improved controls and documenting all procedures. Once a manual is finalized, all staff will be trained on its use and requirements.

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MINUTES TO PUBLIC MEETINGS

General
Summary of Findings and Recommendations:

- Failure to adequately prepare and publish minutes of seven previous public meetings of the School Reform Commission

School District's Response:

- As required, minutes of all public meetings of the School Reform Commission are prepared and published, and are current through Fiscal Year 2005. Despite this fact, the seven meetings from previous years missing transcriptions will be prepared and provided prior to the end of this calendar year.

STATUS OF OTHER PRIOR YEAR FINDINGS

Journal Voucher Procedures – Authorization Weaknesses
Summary of Findings and Recommendations:

- Finding resolved and closed

Allocation Procedures
Summary of Findings and Recommendations:

- Finding resolved and closed

Unrecorded Donated Property
Summary of Findings and Recommendations:

- Failure to properly record donated property on Personal Property Inventory book of records lending to the suspected understatement of $580,000

School District's Response:

- The School District maintains a personal property inventory system for all departments and schools. The inventory information is distributed at least two times during each calendar year and requires that each location verify that all items valued over $500 are contained in the list. Personal Property Inventory

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Procedures and accompanying guidelines are in place and widely disseminated throughout the district. In addition, all processes, procedures and guidelines in this respect are also included in the Principals Financial Training Manual.

- After further investigation, Auditors informed representatives of the School District that the suspected property not recorded was "inferred" from information contained in the minutes of a School Reform Commission document dated over two years ago. Auditors did not provide any other additional or verifiable information regarding this purported donated property or its valuation.

- Because of the lack of specific information such as receiving records, proof of delivery of property, and detailed item listings, the School District is unable to verify that such property exists and the purported valuation of such property. Nonetheless, the School District will make every attempt to research the purported recipient locator and record this property if it can be determined that the property was, in fact, received.

Categorical Funds – Child Care Account
Summary of Findings and Recommendations:

- Finding resolved and closed

Year-end Expenditure Review Procedures
Summary of Findings and Recommendations:

- Finding resolved and closed

Documents in Suspense Backlog
Summary of Findings and Recommendations:

- Finding resolved and closed